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Backgrounder

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Failing to Go the Extra Mile:
A Comment on the February 20 Federal Budget

by

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Once again the federal budget has proved to be a better exercise in public relations than in public policy. If the government really believes that getting the nation's debt burden under control is important, it should have made deeper cuts in the deficit in its recent budget.

Given the urgency of getting control of the massive debt burden, Finance Minister Michael Wilson should have made deeper cuts in the deficit for fiscal year 1990/91. He should not only have met the targets set out in the April 1989 Fiscal Plan, but surpassed them.

The budget raises serious questions related to:

- the marginal reduction in the deficit (from $30.5 billion to $28.5 billion), given the size of the federal debt ($350 billion);
- the questionable manner in which some "savings" were found (for example, acceleration of payments by the Bank of Canada);
- the lack of a comprehensive strategy for reviewing federal-provincial cost sharing and the efficiency and utility of specific government programs; and
- the high degree of vulnerability of the projected fiscal plan to errors in interest-rate forecasts.

Prior to the February budget, the C.D. Howe Institute recommended several major criteria for a sound fiscal strategy, including that:

- growth of spending and the associated tax burden should be controlled;
- deficits and the debt should observe limits related to the size of the economy; and
- fiscal policy should be consistent and should not disrupt the long-term plans of individuals, governments, and corporations.

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Although the budget contains measures that satisfy some of the Institute's specific recommendations — for example, further privatization of Crown corporations; the cancellation of some major projects and programs — in general, it falls short of the Institute's expectations:

- the deficit is to be reduced too slowly;
- there is no overall plan to control expenditures over the long term; and
- some major expenditure restraints and reductions have been made at too short notice for those affected to adjust their financial planning.

In its pre-budget submission, the Institute recommended that the government go beyond the April 1989 Fiscal Plan. Recognizing that the government's April 1989 plan had already been negatively affected by the transitional effects of the Goods and Services Tax (GST) and higher interest rates, the Institute felt that the government should achieve a deficit in the region of $26 to $26.5 billion in 1990/91. Thereafter, the Institute's proposal was to reduce the deficit by an average of $5 billion a year over the following four years.

This action would have put the deficit and debt on a more solid downward track than the government's plan, as the accompanying table shows. By concentrating the savings in 1990/91, the compounded gains in the cost of servicing the debt would help to stabilize the debt-to-GDP ratio earlier than the government had planned.

It appears that the government's new deficit targets have been chosen with an eye to satisfying skittish financial markets rather than confronting the more profound problem of the path of the deficit and, by extension, the debt burden. The cost of servicing the debt is now so large that important policy decisions about the country's future are being compromised. Program allocations are frozen, reduced, or eliminated in order to hit a deficit target, not because the funding of the program can no longer be justified by public support or purpose. Occasionally, such considerations coincide with the goal of deficit reduction (as in the cancellation of OSLO and Polar 8) but by and large they are secondary.

The Institute has urged the government to target a long-term expenditure path and to re-evaluate all programs in the context of the needs of the 1990s. It is crucial that this task be undertaken as soon as possible in order to make room for the emerging needs of the environment, manpower retraining, and child care. Many government programs first saw the light of day in the 1960s and no longer satisfy the requirements of today, let alone tomorrow. Nor does their funding square with the economic realities of the 1990s. The action to contain the cost of transfers to the provinces is a good example of how *not* to tackle fiscal policy. The federal and provincial governments need to work out a better plan for the financing of welfare, health and postsecondary education. The unilateral chipping away at the growth of existing arrangements does not deal with the real issues.

The Institute also disagrees with how the government has opted to restrain expenditures. The across-the-board freezes (such as Established Programs Financing (EPF) transfers and payments to Crown corporations) and the broadly applied caps to program growth (Canada Assistance Plan, Indian and Inuit programs, Official Development Assistance) do not reflect clear ordering of priorities. The Institute also would have preferred to see greater restraint on subsidies and other transfers to business, agriculture, and Crown corporations.

The Institute fully agrees with the federal assessment of the deficit as a national problem and that it is necessary to examine both federal and provincial expenditures and revenues in trying to improve Canada's public-sector debt position. However, by reducing expected transfers to other governments at such short notice, the government has not met the In-stitute's expectations of consistency in fiscal policy. Furthermore, to the extent that the provincial governments may not wish, or be able, to find offsetting expenditure savings, the public-sector debt will not be reduced.

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The Deficit and the Debt-to-GDP Ratio, fiscal years 1989/90 to 1994/95

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95
Deficit ($ billions)						
April 1989 budget	30.5	28.0	24.4	20.6	15.0	n.a.
February 1990 budget	30.5	28.5	26.8	21.0	14.0	10.0
C.D. Howe recommendation		26.1	19.0	15.3	9.3	2.9
Debt-to-GDP Ratio (percent)						
April 1989 budget	54.5	56.2	56.4	55.9	54.7	n.a.
February 1990 budget	54.4	55.9	56.2	55.5	53.7	51.6
C.D. Howe recommendation		55.6	55.1	54.0	52.1	50.0

Note: The comparison between the debt-to-GDP ratios in the April 1989 and February 1990 budgets is distorted by historical upward revisions to the GDP

Sources: Department of Finance; Statistics Canada, *National Income and Expenditure Accounts*; C.D. Howe Institute.

This is the third time that the present government has adjusted the formula for its transfers to finance health care and post-secondary education (EPF) without coming to grips with the underlying question of the appropriate way to finance and deliver these two services. The most efficient way is likely to be found by a series of experiments by individual provinces.

Debt service is not only a constraint on fiscal policy, it is also the component of the budget forecast that is at greatest risk. Unforeseen international developments as well as a worse performance for Canadian inflation than the Department of Finance is predicting could knock the deficit and debt targets far off even the revised track. The sensitivity analysis in the budget shows how far the outcome could be off the mark — a 1 percent increase in interest rates raises the deficit by about $1.7 billion in the first year. The government, by spreading its expenditure reductions and management initiatives over two years, has weakened the effect of the package's impact on the debt-service charge.

The Finance Minister can be commended for keeping to the current year's deficit target. The problem is the next two years. The Institute is disappointed that the government did not go the extra mile.

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